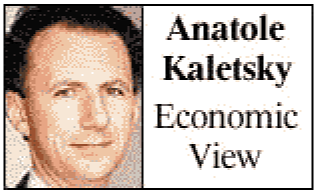
May 9 2000 **ECONOMIC VIEW**



Rapid growth is the key for recovery of the euro

How undervalued is the Euro?

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AT LONG LAST, it seems that the euro has landed. It may still be premature to call the turn of the euro, since nobody can identify precise market turning points except by pure luck, but it is possible to say something important about the underlying economic and financial forces that ultimately determine currency trends.

The balance of global economic and financial forces is now, *finally*, tilted in favour of a stronger euro. On reading this statement you may be tempted to drop this page in disgust, suspecting that I am about to reprint yesterday's daft communiqué from the euro finance ministers' summit or the even more absurd appeal for calm directed at the European public over the weekend by Wim Duisenberg, the President of the European Central Bank. But before you dismiss the rest of this article as another silly exercise in misguided euro-boosting, let me explain why I emphasised the word "finally" in the sentence above.

Unlike the vast majority of economists, politicians and investors, who have for years been wrongly predicting that the euro would rise and the dollar would fall, I have long been a eurosceptic. I have long believed that the euro (and before it the German mark) was fundamentally overvalued, while the dollar was fundamentally cheap. I have believed in a weak euro/strong dollar more or less continuously since 1990, when the launch of the single currency project doomed Europe to a decade of recession, at exactly the time when the US economy was taking off on its greatest expansion for 50 years.

Since the summer of 1996, when Britain had clearly overcome the economic and political crises precipitated by the ERM debacle, I have complemented my faith in a strong dollar with the even more controversial belief that sterling would rise strongly against both the euro and the mark.

The fact that I happened to be broadly right about these currency trends in the past does not, of course, make my conjectures about the future any more reliable. Still less does the shift in my views about the euro's market value imply any kind of Damascene conversion in favour of the single currency as a political project or a sudden dawning of respect for the antediluvian monetarist ideology of the Maastricht Treaty and the ECB.

My purpose in mentioning the intellectual journey that has led to my new-found belief in a strengthening euro, is simply to emphasise that many things have changed in the past few months. And when reality changes, it is often a good idea to change one's mind.

What, then are the changes in economic and market conditions suggesting a reversal of the euro's long downward trend? I think they can be divided into three groups.

First and foremost is value. At the time of its launch, just over a year ago, the euro was preposterously overvalued against the dollar on most measures of relative costs and prices. Since most economists and investors believed, to the contrary, that the euro was still fundamentally undervalued, even at $1.19, this point needs more detailed discussion than the other two.

Until recently, the euro was overvalued in the simplest, most common-sense meaning of the word. It was cheaper to buy things and to do business in America, and even in Britain, than it was in most of euroland. While nobody believes that currencies can adjust to create absolute equality between the costs and prices in different economies, common sense does suggest that exchange rates are out of kilter if they result in identical goods fetching vastly different prices in economies at similar stages of development, such as the US, Germany and Britain.

Thus, a comparison of prices and costs gives one important clue to currency valuations. Many economists incorporate fallacious assumptions about productivity growth, long-term capital flows, "output gaps" and "natural" rates of unemployment in their calculations of "equilibrium" exchange rates.

This is the mistake behind the IMF's recent estimate that the euro's "fair value" at $1.30 or more. The approach to value which I find more useful is to compare the costs of employing an hour of labour, including wages, payroll taxes and other social charges. My calculations, based on the annual figures published by the US Bureau of Labor Statistics and the Swedish employers' federation, show that from 1995 to 1999 German labour costs were 45 per cent to 80 per cent higher than US levels, but that the gap has now narrowed to only 18 per cent. In France and Italy, labour is now 25 per cent cheaper than it is in America - a dramatic improvement on the situation that prevailed throughout the 1990s when costs in France and throughout the 1990s when costs in France and Italy were very close to the US level.

A different, but related measure of currency value is presented in the charts, which show trade-weighted exchange rates adjusted by the IMF's estimates of changes in labour costs and productivity growth. The top chart shows that Germany, after a long period of overvaluation and uncompetitiveness, has now returned to its long-term average real exchange rate, although this average is distorted upwards by the exceptional and unsustainable strength of the mark following the ERM crises of 1992 to 1995). Meanwhile, for France the real exchange rate is now exceptionally competitive and competitive conditons in Italy are by no means bad. This chart also illustrates two other interesting points. The spectacular decline of the Republic of Ireland's real exchange rate goes a long way to explain the Irish economic miracle.

But value alone is never sufficient to reverse a market trend - and anyway the euro was already quite reasonably valued when it fell through parity against the dollar. If it is now "overshooting" on the downside, experience shows that such overshoots can go far below fair value and can persist for months, if not years.

At this point I must turn to my other reasons for believing that the markets may be near a turning point.

Market sentiment against the euro seems finally to be near a bearish extreme. Currency dealers who were telling their clients back in 1999 that the euro would supplant the dollar within months as the world's most popular reserve currency have now shifted to the other extreme. They call the euro a "toilet-paper currency" and warn that, without massive ECB intervention, its value will fall to 80 cents, 60 cents or beyond.

This change in sentiment is crucial because the widespread overoptimism about the euro widespread overoptimism about the euro, especially among large long-term investors such as Japanese insurers, has paradoxically been one of the main factors dragging the currency down. These investors have lost such vast amounts of money on their euro investments, that each time the currency appreciated, they seized this as an opportunity to cut their losses and sell. As these long-term investors capitulate and sell their holdings, the chances of a lasting reversal steadily improve.

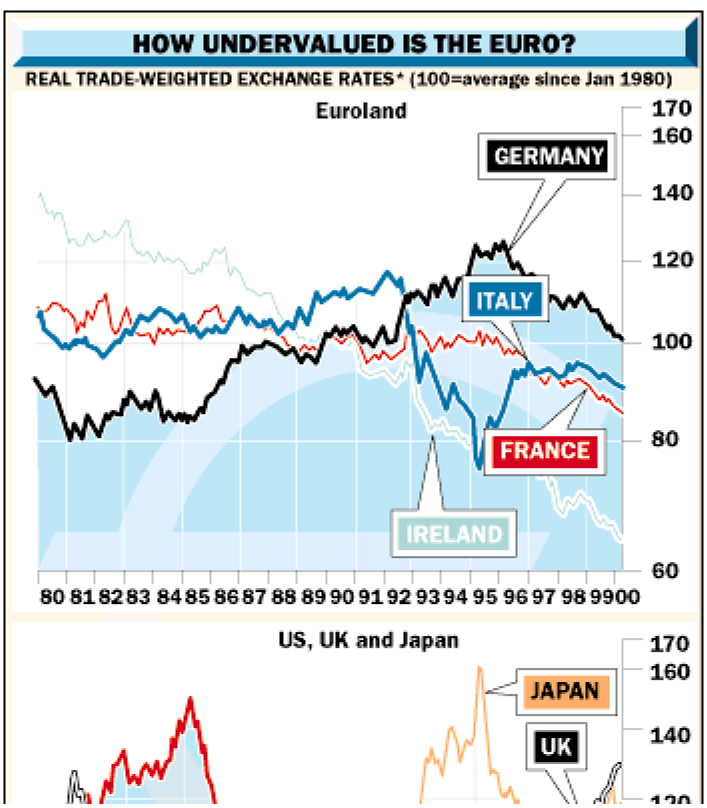
From this point of view, another positive indicator was the recent announcement by George Soros that he would curb his speculative activities, in part because of big losses he had sustained by misjudging the euro. Mr Soros suggested that his decision marked the "end of an era" of hedge fund investments based on big macroeconomic judgments, such as his celebrated speculation against sterling in 1992. In reality, however, his announcement may have been a classic contrary indicator.

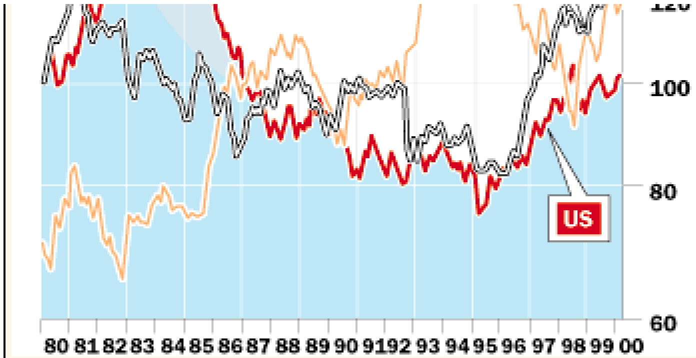
Rather than marking the end of macroeconomics as an influence on investment, the arrival of the euro as a second great reserve currency, has actually made it more important for both investors and government officials to get their macroeconomic judgments right. After the capitulation of speculators such as Mr Soros and long-term investors such as the Japanese, the markets will be forced to refocus on the economic fundamentals in assessing the euro. When they do this they will see that economic conditions in Europe, as well as value, have moved in the euro's favour during the past few weeks.

This leads me to my third reason for expecting the euro to turn. The European economy is growing strongly and this growth is no longer likely to be hobbled by an overly restrictive monetary policy from the ECB. Until the past two weeks there was a serious danger that the ECB would panic in response to the euro's weakness and start aggressively raising interest rates. If this had happened, the European economic recovery would have aborted and the euro would have collapsed.

Fortunately, however, the ECB did not panic. It raised interest rates only marginally as the euro slid, first below $1 and now below 90 cents. The ECB would have done better still - both for the euro and for Europe - if it had not raised interest rates at all in response to the currency weakness. The main point, however, is that the scope for further monetary tightening in Europe is now very slight. The ECB may raise interest rates once again to 4 per cent in the next few weeks, but after that interest rates will probably remain on hold in Europe, giving the economy a chance to accelerate from 3 per cent to 4 per cent growth.

Rapid growth, not higher interest rates, is the tonic needed today by the euro. If the ECB has begun to understand this, then recovery may really lie ahead, both for the euro and for Europe.





*IMF estimates, allowing for changes in relative unit labour costs

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